



Court Broadens Tax Shelter Exception to Tax Practitioner Privilege

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Last month, the federal district court of the Northern District of Illinois held that Valero Energy Corp. had to provide the IRS with many documents it had previously withheld by claiming that the documents were confidential communications between a federal tax practitioner and its client and protected by the tax practitioner's privilege pursuant to Section 7525. *Valero Energy Corp. v. United States*, No. 06 cv 06730 (N.D. Ill. 08/01/08) (Valero II). This case is important to the future application of the tax practitioner's privilege as a result of the court's conclusions with respect to the definition of a tax shelter and the word "promotion" for purposes of the exception to the privilege dealing with communications with respect to the promotion of a tax shelter. Code Section 7525(b).

The tax practitioner's privilege, Section 7525, was enacted in response to the Supreme Court's decision in *Arthur Young v. U.S.*, 465 U.S.805, where the Supreme Court held that there was no common law privilege to protect communications between an accountant and client. Section 7525 provides a privilege with respect to tax advice in the form of confidential communications between a client and a federally authorized tax practitioner to the same extent that such communications would be protected if between an attorney and client. "Tax advice" is defined in Section 7525(a)(3)(B) as advice given by a tax practitioner with respect to a matter that is within the scope of the individual's authority to practice before the IRS. The privilege is not applicable to communications in connection with the promotion of the direct or indirect participation of the person in any tax shelter, as defined in Section 6662(d)(c)(iii).

Procedural History — Valero I

Valero merged with a Canadian company in 2001. Valero retained Arthur Andersen LLP to provide advice on certain financial instrument transactions proposed by another accounting firm, resulting in approximately \$46 million in U.S. tax savings for 2002. Subsequently, the IRS initiated an examination into Valero's tax liabilities for 2002 and 2003, focusing on deductions claimed under international provisions. The IRS served a summons on Arthur Andersen LLP, seeking all documents relating to tax planning, tax research or tax analysis in connection with Valero's taxes for 2001, 2002 and 2003. Valero responded by filing a petition to quash the summons on the grounds that it was overbroad and privileged under the work product doctrine and the tax practitioner's privilege under Section 7525.

In 2007, the court denied Valero's petition to quash ordering Valero to turn over non-privileged documents. However, the court did find that certain documents were protected from disclosure under the tax practitioner's privilege. *Valero Energy Corp. v. United States*, 100 AFTR 2d 2007-6473 (N.D. Ill. 2007) (Valero I). After an in camera review, the court determined that the documents at issue were prepared in the ordinary course of business, with the possibility of litigation being a secondary consideration at best. The court held that the documents were not privileged under the work product privilege since Valero hired Arthur Andersen with an eye toward the complex nature of the transaction.

Valero also argued that some of the information sought was privileged under the tax practitioner's privilege. The IRS responded by arguing that the tax shelter exception to the tax practitioner's privilege applied. The court held that the IRS did not prove the avoidance of taxes was a "significant purpose," emphasizing that the government only focused on the tax consequences. The court held that the tax shelter exception to the tax practitioner's privilege did not apply merely from a showing of significant tax benefits from the transaction.

Valero II — The District Court Revisits the Question of Tax Practitioner Privilege

In Valero II, the United States moved for an order enforcing the summons issued to Arthur Andersen, seeking production of documents withheld under claims of privilege. Valero argued that the tax practitioner's privilege protected the withheld documents from production.

The government argued that Valero retained Andersen to provide Canadian tax advice, business advice and accounting services. The parties agreed that the tax practitioner's privilege does not protect documents relating to Canadian tax advice because a tax practitioner cannot practice Canadian tax law before the IRS. The parties also agreed that business advice is not privileged under the tax practitioner's privilege.

Again, the court held an in camera review of the withheld documents, considering the totality of the circumstances to each document. With respect to communications from Andersen to Valero, the court noted, just as communications from an attorney to a client "are privileged only if they constitute legal advice or tend to directly or indirectly reveal the substance of a client confidence," communications from a tax practitioner to a client are also only privileged in those circumstances. Employing that framework, the court determined that many of Valero's documents failed to meet the standard for Section 7525 protection, since they did not reveal advice or

communications from the client. Therefore, the court held that tax cover sheets, engagement letters and other internal documents which do not reflect "practitioner-client communications" had to be produced.

The Tax Shelter Exception

Next, the court addressed the tax shelter exception. Under the tax shelter exception, "the tax practitioner privilege does not apply to any written communication between a federally authorized tax practitioner and a director, shareholder, officer or employee, agent or representative of a corporation in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii))."

The court first held that to find a tax shelter, there doesn't have to be proof that the underlying transaction lacked economic reality or was done solely or primarily for tax avoidance. All that must be shown is that the communication relates to a plan or arrangement, a significant purpose of which was the avoidance or evasion of federal income tax. In addition, the court also held that producing evidence of a legitimate business purpose was not sufficient to show that the transaction did not have a 'significant purpose of avoiding U.S. income tax. As a result, the court set a low burden on the government to show applicability of the tax shelter exception.

The court then addressed whether the communications between Andersen and Valero constituted "promotion" of a tax shelter. The court dismissed the definition of a promotion set forth by *United States v. Textron, Inc.*, 501 F. Supp. 2d 138, 148 (D.R.I. 2007), instead holding that "promotion" applies to "a person who organizes or assists in organizing a tax shelter." The *Textron* court had held that the word "promotion" limited the scope of the tax shelter exception to communications with respect to selling or marketing pre-packaged tax shelter products. The court found that "unlike the tax advisers in *Textron*, Andersen was not simply reviewing historical transactions and advising Valero on what their likely future tax consequences would be; instead, it was itself advising Valero on proposed Canadian refinancing transactions."

Conclusion

Of particular concern is that under the Valero court's definition of a "tax shelter" and the word "promotion" it will be easier for the government to argue and win the tax shelter exception to the tax practitioner's privilege.

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